Michael C Bonello: Single currency issues – a central bank perspective

Speech by Mr Michael C Bonello, Governor of the Central Bank of Malta, at the conference "The Euro - the impact on business", organised by the Malta Federation of Industry, 16 January 2003.

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By way of introduction, it is important to stress that Economic and Monetary Union (EMU) and the euro are key aspects of the Treaty on European Union. They are a logical consequence of the process of European integration, and in particular of the economic rationale of increased trade as the driving force for the further integration of citizens, institutions and markets. Indeed, the arguments for more closely integrated markets, namely that greater trade and financial integration will increase economic efficiency and improve welfare, can equally be made for a single currency.

In the case of the EU, the advantages of a single market postulated by economic theory appear to have been amply realised. Since internal borders were removed ten years ago, it is estimated that the Single Market has helped to create 2.5 million extra jobs; the EU's combined GDP in 2002 was 1.8%, or euro 164.5 billion, higher than it would have been; and each household was on average 5,700 euro better off.[1] Market opening is, therefore, not only good economics but also very good social policy.

Further benefits can be expected to flow from the introduction of the single currency. A recent study has in fact suggested that currency union approximately doubles trade.[2] And specifically with regard to the euro, another study has concluded that in the case of Hungary, euro area membership may raise the GDP growth rate by 0.6 to 0.9 of a percentage point in terms of a twenty-year average.[3]

The euro thus lies at the very heart of the EU and it is therefore no surprise that EU membership carries with it an obligation to participate in EMU and to adopt the single currency.

Participation in EMU requires a number of preparations, relating to:

- the legal transposition of the acquis on EMU into national law;
- fulfilment of the Maastricht criteria; and
- the setting-up of the necessary institutions and mechanisms for the co-ordination of fiscal and economic policy, which remain at the discretion of national governments.

While the Central Bank will be expected to play a leading role in the event of Malta taking up the offer of EU membership, the country's eligibility to join EMU and its ability to participate on an on-going basis thereafter, without pressures arising in other sectors of the economy, also depend on the commitment of the other policy-makers. This is because the Maastricht convergence criteria include not only a fiscal dimension, which is clearly outside the remit of central banks, but also others that are only partly influenced by the actions of central banks.

This being said, the exchange rate criterion, which relates to the Exchange Rate Mechanism (ERM II), falls well within the competence of central banks. I, therefore, propose to focus today on the implications of this criterion for the Central Bank of Malta.

The implications of the single currency for exchange rate policy

Exchange rate policy is determined by the Minister of Finance on the basis of recommendations made by the Central Bank. In practice, this means that the Bank must have a considered view on which exchange rate strategy is appropriate at any particular time. A key task of the Bank in the run-up to EMU, therefore, would be to assess the implications of the exchange rate criterion for the evolution of

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[1] European Commission, Directorate General Internal Markets. "The Internal Market – Ten Years Without Frontiers". Brussels, January 2003.

[2] Andrew K Rose, "The Effect of Common Currencies in International Trade: A Meta-Analysis", (draft) University of California, Berkeley, 8 April 2002

[3] Attila Csajbok, Agnes Csermely, "Adopting the Euro in Hungary: Expected Costs, Benefits and Timing", National Bank of Hungary, Occasional Papers 24.

policy. This criterion requires, as a condition for joining EMU, that a country participate in ERM II for at least two years without resorting to a devaluation against the euro.

Timing issues related to entry in ERM II

In this process a first decision relates to the exchange rate strategy to be pursued in the interim period between now and entry into ERM II after EU accession. The EU Treaty is not restrictive in this regard. Any exchange rate strategy is acceptable as long as it contributes to real convergence and macroeconomic stability, and is compatible with ERM II by the time of entry in the mechanism. And since pegs to currencies other than the euro are incompatible with ERM II, our current exchange rate regime, which includes the euro, the US dollar and sterling, would need to change.

In view of the positive experience with a fixed exchange rate regime and the absence so far of pressures on the lira during the on-going capital account liberalisation process, our strategy in this regard is to maintain this fixed regime but to gradually reduce the weight of the US dollar and sterling until the euro is the sole reference currency. This adjustment should not pose unsurmountable difficulties given that the euro already carries a weight of 70%. As for the timing and pace of the move to a full euro peg, these would depend, among other things, on the expected date of entry in EMU, which is conditioned by the two-year period embedded in ERM II, and also on the pace of the economy's convergence to EU income levels and economic structures.

Issues raised by Malta's prospective participation in ERM II

During the ERM II phase, which for most new members would start soon after EU accession, the Maltese lira will be fully pegged to the euro and the exchange rate would be allowed to fluctuate by up to ±15% around a central rate to be agreed with the European Central Bank (ECB). A major issue, therefore, concerns the level of the central rate and the size of the fluctuation bands. Although the central rate could be re-aligned if it cannot be sustained within the chosen bands, the initial determination of this rate is crucial because it signals to the market what the authorities consider to be the appropriate level of the exchange rate.

Determining the appropriate central rate, however, is not an easy task. While the available evidence suggests that in the current economic environment the Maltese lira exchange rate is sustainable at prevailing levels, the Central Bank is nevertheless undertaking the necessary econometric work in order to estimate an equilibrium rate.

The choice of the fluctuation bands is equally important. A narrow band has the advantage of limiting exchange rate risk and contributing to the Bank's credibility in the area of monetary policy. A wider band, on the other hand, would ease pressures on the monetary authorities to intervene in the foreign exchange markets to maintain the exchange rate within the agreed bands. Given Malta's dependence on foreign trade and investment, the Bank's commitment to price stability and its positive track record with a fixed peg, a narrow band, and the lesser degree of uncertainty and volatility associated with it, would be preferable. I should add that as real convergence is progressively achieved and as structural reforms are implemented, a narrow band should become even more feasible.

A smooth transition to EMU indeed requires more than satisfying the exchange rate criterion and the other four Maastricht criteria. To be able to implement the ECB's monetary policy without difficulties, new euro area members should also achieve a minimum degree of real convergence. The ECB will, in fact, give its opinion on the level of real convergence achieved by each country before it is allowed to enter EMU. In reflecting on the future evolution of exchange rate policy in Malta, the Central Bank will thus also continue to monitor developments in the rest of the economy, particularly in so far as they affect the sustainability of the Maastricht criteria.

Implications of the single currency for the composition of the external reserves

From the date of EU accession until the end of the ERM II phase, Malta would qualify as "a Member State with a derogation", the lira would remain the national currency and monetary policy would continue to be set by the Central Bank. As noted above, however, in the process of moving from EU accession to ERM II the euro would progressively gain in importance as the reference currency in the currency basket until it finally ceases to function as a foreign currency on joining the EMU. In addition, upon EU accession the Central Bank will be expected to transfer an amount of external reserves, other than the euro and a number of other specified currencies, to the ECB. In order of time, therefore, the composition of the external reserves of the Central Bank would change to reflect, first, the move towards a 100 per cent peg to the euro, then the transfer of a portion of the non-euro reserves to the ECB, and lastly the adoption of the euro as the national currency. The Bank is currently studying how the necessary adjustments could take place without increasing its exposure to exchange rate risk. Given the implications which the simultaneous move out of euro assets by all acceding countries could have for the international value of the euro, moreover, the Bank - in common with the central banks of the other acceding countries - would co-ordinate these adjustments with the ECB.

Operational framework for open market operations and reserve management

Upon joining EMU, the Central Bank would act as agent for the ECB in the management of the ECB's foreign reserve assets and in the implementation of monetary policy. At this point, the Bank would practically act as an interface between those parties eligible to participate in the euro area's open-market operations and foreign exchange transactions and the ECB. This function has implications for both the Bank's institutional set-up and its operational framework.

First, the Bank must have the necessary legal power to carry out these tasks. In this regard, the Central Bank of Malta Act already permits the Bank to hold and exchange virtually any financial instrument and foreign asset. Additionally, however, it requires a good understanding of the operational framework governing such transactions, including the financial instruments and legal documentation that apply to transactions with eligible counterparties, the criteria which determine a counterparty's eligibility to participate in these transactions and those that determine whether a particular asset can be used as collateral. Whereas most of the instruments currently used by the Central Bank are already in line with those of the European System of Central Banks (ESCB), further adjustments are necessary to achieve full compliance. To this end, the Bank has set up a Monetary Operations Committee and a Foreign Reserves Operations Committee to identify the appropriate additional adjustments to the Bank's operational framework.

The ability to interface with the ECB also requires that the systems which each Member State uses for the settlement of cross-border payments and the transfer of assets – in other words, the payment system and the securities settlement system – are somehow linked with those of the other members. This linkage is a prerequisite for the efficient conduct of monetary and foreign exchange operations in the euro area. As far as the domestic payment system is concerned, the new Malta Real-time Inter-Bank Settlement System (MaRIS) already provides for the immediate delivery and settlement of wholesale financial payments in line with principles governing the EU's TARGET system. This is an innovation whose advantages the business community in particular will come to appreciate in time. Meanwhile, discussions between the Central Bank and the Malta Stock Exchange are underway on the changes that need to be made to the securities settlement system.

Of course, having in place the right systems which permit funds and security titles to be transferred between Malta and the euro area is not enough. A key task of every central bank is that of safeguarding the stability of such systems. Whereas for the Central Bank of Malta this holds true irrespective of EU membership, one cannot overlook the fact that the ECB has a direct interest in the stability of payment systems throughout the EU. Appropriate oversight mechanisms are accordingly being put in place

Information - another important element in the ESCB's strategy

In this regard, both the Central Bank of Malta and the ECB would require continuous access to the necessary information to enable them to gauge whether the payment and settlement systems are performing well. Such information, and a minimum level of forecasting capabilities, are in fact necessary for the fulfilment of all the tasks of a central bank, particularly for the maintenance of financial stability and the formulation of monetary policy.

Central banks of accession countries will therefore assume statistical reporting obligations towards the ECB as soon as they become members of the ESCB, that is upon EU accession, although these obligations are less onerous than those which apply to euro area members. This future obligation should not pose any difficulty for the Central Bank as the existing legislation already gives it the power to access information directly and to publish it.

In addition to these enabling powers, however, the Bank must also be equipped with the necessary technological and operational infrastructure and communication facilities to enable it to receive information from reporting agents and to forward it to the ECB. It must also ensure that the relevant information follows the agreed methodology. Recognising this future obligation, the Central Bank almost three years ago established a broad-based representative committee to identify the changes required in the way monetary and financial statistics are classified and reported. This work has been completed and the reporting forms have been updated accordingly. To facilitate the collection of this information, moreover, a common database is being established between the Bank and the Malta Financial Services Authority. In the meantime, the Bank and the National Statistics Office are working to establish a common direct reporting database which will permit the dissemination of balance of payments related data to the ECB and EUROSTAT.

The steady flow of information between the ECB and the national central banks is equally important from the point of view of transparency and effectiveness. The latter requires that ECB decisions be communicated in each Member State as early as possible. For this purpose, the Central Bank's communications facilities will have to be upgraded. In particular, the Bank must have an archiving system capable of receiving, storing, retrieving and sending working documents to the ECB. Such a system is being developed.

Conclusion

Joining a common currency area clearly involves a complex and multifaceted process with implications of both a substantive and technical nature. This has become particularly evident as the emphasis of the Bank's preparations has shifted away from legislative issues to the implementation phase. Much useful work has already been done, the Bank has been considerably strengthened as a result and we are fully in step with the central banks of other accession countries.

Looking immediately ahead, the Bank's integration within the ESCB now requires it to be represented on all the decision-making organs of the ECB. In fact, the Bank has already been invited to nominate a representative to sit on each of the twelve committees of the ECB in an observer capacity as from April. These technical committees deal with issues ranging from accounting, auditing and legal matters and banking supervision, to market operations, payment and settlement systems, statistics and information technology.

The early presence of accession countries' central banks on these committees serves to underline the fact that adopting the single currency involves more than the physical introduction of euro notes and coins would suggest, although this, too, will be one of the Central Bank's responsibilities should the day come when euro notes and Maltese-designed euro coins become legal tender. Indeed, the adoption of the euro touches upon the most fundamental aspects of a central bank's core functions, its operational framework and its institutional set-up. It could be described as the start of a new and challenging phase that will give another dimension, not only to the Central Bank itself, but to policy-making in Malta more generally. And, not least, as may be seen from the papers presented at this seminar, the single currency also holds out the prospect of significant efficiency gains and, therefore, of financial savings.